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Section 701 Report	)	Docket No. PI2016-3
	)	

Comments of Former Utility Regulators

(June 14, 2016)

As former utility regulators, we submit these comments in response to the Postal Regulatory Commission's ("Commission") call for public comment on its upcoming report to the President and Congress pursuant to Section 701 of the Postal Accountability and Enhancement Act of 2006 ("PAEA").[1] We comment primarily by endorsing the attached white paper authored by Raymond Gifford, Greg Sopkin and Bryan Tramont, also former utility regulators as indicated in the white paper. We believe that this paper accurately describes the variety of approaches utility regulators have employed to deal with the issues presented when a monopoly provider of utility services also provides services in competitive markets. We understand this is a core issue for this Commission as well.

The paper provides an overview of how utility regulators, across a variety of sectors, have historically dealt with these issues. While we don't profess deep familiarity with PAEA, we note that it does require the Commission to address issues that are quite familiar to us, as those issues are aptly described in the white paper. For instance, PAEA prohibits the subsidization of the United States Postal Service's

[1] Section 701 Docket, *Notice and Order Seeking Comments on Report to the President and Congress Pursuant to Section 701 of the Postal Accountability and Enhancement Act of 2006*, Docket No. PI2016-3, Order No. 3238 (April 14, 2016) ("Notice").

("Postal Service") competitive products by its market-dominant (i.e., monopoly) products.[2] It also charges the Commission to ensure that Postal Service competitive products cover the costs attributable to those products, and to ensure that all competitive products collectively cover what the Commission determines to be an appropriate share of the institutional costs of the Postal Service.[3] In our own sectors, we have experienced firsthand the challenges of implementing a complex statutory scheme to regulate a provider of both monopoly and competitive services in a fast changing economy. We urge you to give the attached white paper full consideration as you deal with these same issues.

Further, we understand from the Notice that this is the Commission's opportunity to make recommendations for any legislation or other measures necessary to improve the effectiveness or efficiency of the postal laws of the United States.[4] As the Commission prepares its Section 701 Report, if it believes that it requires better statutory tools to prevent cross-subsidization, and ensure that competitive products do cover their costs, we urge the Commission to emphasize that fact. For instance, a theme presented in the white paper with which we strongly concur is that effective accounting separations between monopoly and competitive services is paramount, and in order for accounting separations to be effective, the regulator and industry participants must be able to understand what activities and products drive costs. Transparency into cost assignment is critical to this exercise. It may be appropriate for

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[2] 39 U.S.C. § 3633(a)(1).

[3] 39 U.S.C. § 3633(a)(2),(3).

[4] Notice at 2.

the Commission to confirm that it has sufficient authority under the PAEA to deal with these issues, and if not, to request additional statutory authority as appropriate.

In conclusion, in our roles as utility regulators we saw value in looking across the various industries we regulated to identify common themes and core concerns that spanned those industries. One of those core concerns was preventing utilities from cross-subsidizing their competitive services, as described in the white paper. We hope that this Commission can similarly benefit by considering the lessons learned in the utility regulation field.

Respectfully Submitted,

/s/

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CROSS-SUBSIDIZATION: APPLYING LESSONS FROM UTILITY REGULATION TO THE UNITED STATES POSTAL SERVICE

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June 14, 2016

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INTRODUCTION

Each of us has significant and broad experience in utility regulation.[1] Based on our collective experience, we believe we can provide the utility regulator's perspective regarding monopoly and cross-subsidization issues, and the importance of protecting captive ratepayers against the effects of cross-subsidization. A particular regulatory concern is that utilities that also offer competitive services may fail to appropriately assign costs to those competitive services, including an appropriate share of joint and common costs. This causes the utility's monopoly services to bear a disproportionately large share of overall costs, and therefore be overpriced, to the detriment of captive customers. It also causes a disproportionately small share of overall costs to be allocated to competitive services, allowing the utility to price those services below cost, to the detriment of fair competition. Both of these outcomes are undesirable.

Similar to the utility context, the Postal Regulatory Commission ("Commission") is tasked by the Postal Accountability and Enhancement Act of 2006 ("PAEA")[2] with preventing the United States Postal Service ("Postal Service") from subsidizing its competitive offerings through its monopoly offerings, and from disrupting competitive markets through an un-level playing field. Specifically, PAEA charges the Commission with enacting and enforcing rules that will prevent the cross-subsidization of Postal Service competitive products by market dominant products, ensuring that each

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[1] Bryan Tramont served as Chief of Staff of the Federal Communications Commission under Chairman Michael Powell, and prior to that served as Chairman Powell's Senior Legal Advisor. Raymond Gifford and Gregory Sopkin each served as Chairman of the Colorado Public Utilities Commission. While the authors are each partners with the law firm of Wilkinson Barker Knauer, LLP, any opinions expressed herein are solely those of the authors.

[2] Postal Accountability and Enhancement Act, Pub. L. 109-345, 120 Stat. 3189 (December 20, 2006), *codified* at 39 U.S.C. §§ 101, *et seq.*

competitive product covers its own attributable costs, and ensuring that competitive products, collectively, cover an appropriate share of the Postal Service's institutional costs.[3] These are familiar principles to us; when a monopoly provider of regulated services is permitted to offer unregulated competitive services, accurate cost allocation, through a transparent and reliable process, is necessary to avoid cross-subsidies.

I. SUBSIDY ISSUES IN REGULATED UTILITY INDUSTRIES

The PAEA charges the Commission with preventing cross-subsidization and unfair market disruption, core regulatory principles well-established in the utility context, because a regulated entity has a natural incentive to leverage the monopoly revenues from sales to its captive customers to finance its competitive ventures. Such cross-subsidization by monopoly products of unregulated, competitive products has long been a primary concern of utility regulators.[4] As stated by Alfred Kahn, Professor of Economics, and former Chairman of the New York Public Service Commission and Civil Aeronautics Board, as long as prices are set "on the basis of some continuing process of allocation of costs between regulated and unregulated operations, there will always be the danger, in principle, of subsidization of the latter by the former."[5]

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[3] 39 U.S.C. § 3633.

[4] For instance, when the Federal Energy Regulatory Commission ("FERC") scrutinized cross-subsidization concerns in considering a merger involving Puget Energy, then FERC Chairman Joseph T. Kelliher observed that: "[c]ross subsidization is not a new responsibility for the Commission, preventing cross subsidies has been at the heart of our economic regulation since the 1930s." Statement of Chairman Joseph T. Kelliher on Puget Energy, Inc., FERC Docket No. EC08-40-000 (April 17, 2008).

[5] Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions,* xxxvi (MIT 1988).

The "danger," specifically, is not just that monopoly-subsidized competitive offerings distort competition[6] in the competitive sector, but more principally, that such cross subsidies harm customers paying for the monopoly regulated services. In the utility context these customers have long been referred to as "ratepayers," and often, "captive ratepayers,"[7] the notion being that they have no choice but to pay the rates that the monopoly provider charges for utility service, as there is no alternative competitive provider. Accordingly, utility regulators have recognized in any number of contexts the danger that the utility may be inclined to overstate costs on the regulated side, leaving captive ratepayers no choice but to pay those rates.[8] And overstated costs on the

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[6] The Commission has also recognized the potential that competitive offerings may distort the competitive marketplace. In its 2011 Section 701 Report to the President and Congress, the Commission emphasized in its recommendation that "proper regulatory review and oversight" would be necessary to ensure that any new nonpostal service offered by the Postal Service "does not disrupt the competitive marketplace." Postal Regulatory Commission Section 701 Report, *Analysis of the Postal Accountability and Enhancement Act of 2006*, at 2 (Sep. 22, 2011). In the same report the Commission noted that, in fact, the United States Government Accounting Office ("GAO") had previously determined that "the Postal Service's entry into these [nonpostal] markets [had previously] resulted in distortion of private markets." *Id.* at 47.

[7] *See, e.g.*, *California v. FCC*, 905 F.2d 1217, 1229 (9th Cir.1990) (discussing structural separation versus accounting and other nonstructural regulations for Bell Operating Companies providing both regulated common carrier services and unregulated competitive services, and noting the FCC's "regulatory task of protecting captive ratepayers and competitors against the damaging effects of cross-subsidization."); *People ex re. O'Malley v. Illinois Commerce Comm'n*, 606 N.E.2d 1283, 1288-89 (Ill. App. 1993) (Illinois Utilities Act, while allowing telecommunications carriers to provide both competitive and noncompetitive (regulated) services "prohibits cross-subsidization and discrimination in order to protect captive ratepayers."); *18 CFR Part 35 Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities*, Notice of Proposed Rulemaking, 115 F.E.R.C. P61210, ¶ 101 (2006) (describing FERC precedent involving affiliate power sales transactions between regulated and unregulated entities, and FERC's charge of "ensuring that the market is not distorted and captive ratepayers are protected.").

[8] *See, e.g.*, *In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, Report and Order, 11 FCC Rcd 20541, 20628, ¶ 171 (1996) (FCC ongoing scrutiny of carrier accounting

regulated side of the ledger means understated costs for competitive products, potentially allowing utilities to unfairly price competitive offerings below cost.[9]

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treatment of payphone assets necessary to continue "protecting regulated ratepayers from cross-subsidies and cost misallocations"); *In the Matter of Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards*, Report and Order, 6 FCC Rcd 7571, 7572, ¶ 2 (1991) ("[T]his Commission has a duty under the Communications Act to protect regulated service ratepayers by guarding against cross-subsidy between basic [regulated] and enhanced [competitive] services."); Submitted Committee Report: Report of the Antitrust Committee, 23 Energy L.J. 211, 240 (2002) (observing that FERC's policies and typical regulatory approval requirements on intra-corporate transactions involving the sale of non-power goods and services "provide the Commission with access to books and records under section 301(c) of the Federal Power Act necessary to enable the Commission to protect ratepayers against inappropriate cross-subsidies.").

[9] *See, e.g.*, *In the Matter of Establishment of Policies and Procedures for Consideration of Applications to Provide Specialized Common Carrier Services in the Domestic Public Point-to-Point Microwave Radio Service and Proposed Amendments to Parts 21, 43 and 61 of the Commission's Rules*, Notice of Inquiry to Formulate Policy, Notice of Proposed Rulemaking and Order, 24 F.C.C.2d 318, 336, ¶ 41 (1970) ("We must not overlook the possibility… that the established carriers may file unduly low or discriminatory tariff schedules and thereby subject the new entrants who increase the competitive character of the market to unfair competition. In this connection we note that AT&T could file tariffs which price its potentially competitive services below cost to prevent or limit entry and seek to recover the losses through cross-subsidy from its monopoly message toll telephone and WATS market."); *Rulemaking on the Commission's Own Motion into the Third Triennial Review of the Regulatory Framework Adopted in Decision 89-10-031 for GTE California Incorporated and Pacific Bell,* Decision No. 98-10-026, Rulemaking No. 98-03-040, 1998 Cal. PUC LEXIS 669, *28 (March 26, 1998) (explaining that the California Public Utilities Commission has established cost-based rate floors for regulated incumbent telephone competitive offerings, to ensure that those utilities "cannot charge prices below the floor rates, using other revenue to cross-subsidize below cost rates to gain a competitive advantage."); *Application of Verizon Virginia, Inc.; and; Verizon South, Inc.; For Approval of a Plan of Alternative Regulation*, Final Order, Virginia State Corporation Commission Case No. PUC-2004-00092, 2005 Va. PUC LEXIS 2, *30 (Jan. 05, 2005) ("a cross subsidy test that includes individual services is necessary to ensure that Verizon does not subsidize below-cost competitive services by more profitable monopoly services."); *Cable Television and Communications Association of Illinois v. Illinois Bell Telephone Company, and Ameritech New Media, Inc.; Complaint for an Investigation and relief from cross-subsidizing transfers in violation of Article IX of the Public Utilities Act*, Order, Illinois Commerce Commission Docket No. 97-0344, 1999 Ill. PUC LEXIS 369, *19 (May 19, 1999) ("If such a cross-subsidy were permitted, the regulated entity could finance

As the FCC succinctly stated the proposition: "[P]rotecting ratepayers from unjust and unreasonable rates is the primary purpose behind the accounting separation of regulated from nonregulated activities, just as it is the purpose behind all of our accounting and cost allocation rules."[10]

While utility regulators have dealt with these issues for decades, we note that the PAEA appears to have first introduced the Postal Service to "modern rate regulation."[11] It did so by adopting the common utility regulation approach of trying to separate costs for monopoly and competitive services into separate buckets.[12] While the Commission regulates the Postal Service's rates for market-dominant services, the Postal Service sets its own prices for competitive services.[13] It is the same in the regulated utility context. This is what makes the issue of accurate cost assignment and allocation so very important, and this is what underpins the Commission's statutory charge to promulgate regulations to prevent cross-subsidization of competitive products.[14]

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below cost, predatory pricing by its unregulated affiliate, with the revenue foregone in the unregulated market being recovered in the regulated market.").

[10] *See In the Matter of Separation of costs of regulated telephone service costs from costs of nonregulated activities; Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to provide for nonregulated activities and to provide for transactions between telephone companies and their affiliates*, Report and Order, 2 FCC Rcd 1298, 1303, ¶ 37 (1986) ("*FCC Separations Order*").

[11] 39 U.S.C. § 3622.

[12] 39 U.S.C. §§ 3621, 3631.

[13] 39 U.S.C. § 3622.

[14] 39 U.S.C. § 3633. Similarly, in regulated utility industries providers are often expressly precluded by statute or rule from engaging in predatory or subsidy pricing, specifically as to using revenues from regulated, non-competitive services to engage in below cost pricing of competitive services. In Colorado, for instance: "The commission shall ensure that regulated electric and gas utilities do not use ratepayer funds to subsidize non-regulated activities." C.R.S. § 40-3-114; *see also* 47 U.S.C. § 254(k) ("A

Utility regulators have long been engaged in "modern rate regulation" and have dealt with these same cross-subsidy concerns, which are present whenever a monopoly provider expands into competitive markets. How can regulators prevent the monopoly from competing unfairly in unregulated markets? We discuss a variety of approaches that have been used in the utility context in Section III, *infra*, including structural separation, line of business restrictions, and accounting separation. The most common, and least intrusive approach, is accounting separation, which attempts to divide costs as accurately as possible between regulated and unregulated services. While there can be differences in the specifics of different approaches, all accounting separation models, in order to be effective, require, at a minimum: accurate cost data; a transparent and reliable process; and direct assignment of costs to the greatest degree possible. We discuss each of these in detail in Section IV, *infra*.

Former Secretary of the Treasury John W. Snow observed that these same fundamental accounting separation truths hold for the Postal Service:

> I would also stress the importance of precise revenue and cost allocation across products as a key element to include in any successful postal reform. We do not believe that the current ability of the Postal Service to allocate costs across products to a 58% tolerance level, thus attributing approximately 42% of total costs to general overhead, is close to being satisfactory. In our view, this large unallocated portion is a sort of "elephant in the room" that forces stakeholders, employees, competitors, the regulator, Board of Governors, USPS management and others to invest substantial time, energy, and expense calculating, debating or contemplating a myriad of important issues. While we recognize cost attribution can be complicated for a company the size and complexity of

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telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition.").

the Postal Service, we do not agree with those who contend that it is not possible to drill down to a much finer cost allocation.[15]

II. UNIQUE ISSUES PRESENTED BY THE GOVERNMENT AS THE MONOPOLY

Before turning to the various approaches used to cabin utility monopolies, we first want to make clear the fact that a governmental entity is acting as a monopoly provider of regulated service doesn't lessen the need to deal with these cross-subsidization and competitive level-playing field issues.[16] If anything it magnifies that need.

Utilities are often government-sanctioned monopolies, as, for instance, with the old AT&T prior to divestiture, or incumbent investor-owned gas and electric utilities, which today typically remain government franchised monopoly providers in their service territory footprints. Apart from sanctioning a monopoly, the government often *is* the monopoly provider of utility service; this is not at all uncommon.[17] The government

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[15] Hearing Testimony the Honorable John W. Snow, Secretary of the Treasury on Reform of the United States Postal Service, Joint Session of the Committee on Government Reform United States House of Representatives and Committee on Governmental Affairs United States Senate, JS-1255 (March 23, 2004), https://www.treasury.gov/press-center/press-releases/Pages/js1255.aspx.

[16] As the D.C. Circuit Court of Appeals recently held, the fact that it may be a government entity providing service doesn't change the fact that the government is still a competitor with the same economic incentives as any other competitor. *See Ass'n of American Railroads v. U.S. Dep't of Transportation*, No. 12-5204 (D.C. Cir. April 29, 2016). The D.C. Circuit rejected Amtrak's argument that, because it is a government entity it was not seeking to advance its own private interest, but rather, was merely complying with a variety of mandatory public interest obligations. The Court concluded that, notwithstanding these obligations, Amtrak was still an "economically self-interested" entity that strove to maximize profits. S*ee also City of Lafayette v. Louisiana Power and Light*, 435 U.S. 389, 408 (1978) ("When [public/government] bodies act as owners and providers of services, they are fully capable of aggrandizing other economic units with which they interrelate, with the potential of serious distortion of the rational and efficient allocation of resources, and the efficiency of free markets . . . .").

[17] *See* UPS Response to Chairman's Information Request No. 1 in Docket No. RM2016-2 (filed 12/15/2015) (citing numerous examples of governmental monopoly utilities).

monopoly utility presents the same cross-subsidy/fair competition concerns as the investor-owned monopoly utility.[18]

Government monopoly utilities also present a further unique set of concerns, as they are not constrained by the same financial realities as private firms. A private firm whose costs routinely exceed revenues would of course be unsustainable. A government provider of competitive services, by contrast, can price its competitive services below cost, provided that the revenues it earns as a monopoly provider of utility services cover any shortfall. For this reason a government monopoly provider of competitive services is not disciplined by the same economic realities as a private competitive firm.[19] This makes accurate cost assignment and allocation under an accounting separation approach even more imperative, as competition from the

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[18] *See generally* R. Richard Geddes, *Case Studies of Anticompetitive SOE Behavior* (Feb. 2014) (summarizing competition between government and private industry in the provision of electricity, water, financial services, postal services, weather forecasting, information, freight transport, mortgage lending, and other activities, and observing that, where possible, government owned enterprises "will expand their revenue base by venturing into new, competitive business lines. They will under-price in those businesses in which they compete directly with private firms and will engage in a variety of other anticompetitive behaviors."), http://www.hoover.org/sites/default/files/uploads/documents/081793992X_27.pdf. Indeed, a recent Commission-sponsored study by Richard Cohen and John Waller observed that the Postal Service has precisely this same incentive to minimize cost-attribution to competitive products in order to maximize its pricing flexibility in competitive markets. Robert Cohen & John Walter, *The Postal Service Variability Ratio and Some Implications* at 1 (2014).

[19] *See, e.g.*, George S. Ford, *The Impact of Government-Owned Broadband Networks on Private Investment and Consumer Welfare*, at 43 (April 6, 2016) ("Private entry does not occur when it is unprofitable, which means that expected revenues after entry are insufficient to cover expected costs," and observing that in the context of municipal broadband "[government] entry will drive some, if not all, private incumbents from the market, or at least substantially reduce their presence and investments and reduce their returns."), http://sglf.org/wp-content/uploads/sites/2/2016/04/SGLF-Muni-Broadband-Paper.pdf.

government can significantly distort competition, discourage new entry, and even drive competitive providers from the market.[20]

Further, based on its ability to self-capitalize through taxation or by recourse to other governmental funding, and other monopoly advantages,[21] a government utility provider can likely sustain losses year-to-year even in its aggregate operations, whereas a private firm obviously cannot.[22] A private firm demonstrating that same trend line would long ago have ceased to exist.

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[20] *See, e.g.*, Joseph Fuhr, *The Hidden Problems with Government-Owned Networks* (2012) (GONs can "actually act to forestall market entry and decrease competition," and "are able to keep more efficient firms out of the market."); Lawrence J. Spiwak, *How Municipal Broadband Railroads Due Process"* (May 19, 2016) ("Municipal entry could very well be a poison pill for private sector investment. Indeed, even the threat of municipal entry makes investors skittish about committing billions of their own money to build Internet networks that would have to compete with uneconomic pricing by a self-subsidized government network."). To illustrate, VOIState, a competitive broadband provider, had started deploying high-speed broadband in Rhea County, Tennessee, but stopped when it learned that the City of Chattanooga might extend its government-backed broadband network into that area. As David Snyder, VOIState's CEO observed: "When I looked at my payroll and my investment risk – and then my government comes behind me and turns that investment into dust – I'm not taking that risk." *Broadband Battle: FCC, Legislature square off over EPB bid to Expand Gig Territory,* Chattanooga Times Free Press, Feb. 26, 2015, http://www.timesfreepress.com/news/local/story/2015/feb/26/broadband-battle/290349/.

[21] According to a recent study, the Postal Service's various monopoly advantages, including its "mailbox monopoly," tax subsidies, preferential borrowing rates, significant real estate holdings, and exemptions from state and local taxes, add up to an estimated $18 billion dollars in annual savings and subsidies for the postal system. *See* Robert J. Shapiro, *The Basis and Extent of the Monopoly Rights and Subsidies Claimed by the United States Postal Service*, March 2015 (Washington D.C.: Sonecon), at 3. (http://www.sonecon.com/docs/studies/Study_of_USPS_Subsidies-Shapiro-Sonecon-March_25_2015.pdf).

[22] In that vein we note that the Postal Service has not been profitable since 2006, and from 2007 through 2014 had losses totaling more than $51 billion. *See* Michael Schuyler, *Troubles at the Post Office* (Sep. 17, 2015), http://taxfoundation.org/article/troubles-postal-service.

These unique issues presented by government monopolies are not new concepts. Dating back to the 19th Century, in the context of competition between municipal and private waterworks, the Supreme Court recognized that competition from a city may be far more destructive than that of a private company, because a city or other governmental unit can "fix such prices as it chose for its water, and might even furnish it free of charge to its citizens, and raise the funds for maintaining the works by a general tax."[23]

III. REGULATING THE MONOPOLY TO PREVENT CROSS-SUBSIDIZATION

Federal and state regulators have employed a number of approaches to curb abuses of monopoly power in competitive markets. These have included aggressive regulatory responses such as full structural separation and line of business restrictions, along with more moderate accounting separation of regulated and unregulated services and costs. As we discuss herein, while accounting separation is less invasive than other alternatives, for this same reason it is also less effective than other, more blunt approaches to preventing cross-subsidization. Accordingly, it is well recognized that reliance on accounting separation fundamentally requires accurate and detailed cost data, along with transparency regarding the particular cost assignment methodologies employed, to inspire confidence in the sufficiency of this approach to separations. The focus is on appropriate transparency and cost assignment with regard to competitive products, which present the cross-subsidization danger if they do not bear their fair share of costs. We want to be clear on this point, as within the domain of the utility's monopoly service it is not uncommon that subsidies exist between different classes of

[23] *Walla Walla City v. Walla Walla Water Co.*, 172 U.S. 1, 11 (1898).

customers or services for legitimate policy or societal reasons. For instance, in telephony, it is common that business customers pay more for service than the utility's actual cost to serve them in order to keep rates lower for residential customers. Similarly, urban customers often pay more for service than the utility's cost to serve them in order to keep rates lower for rural customers. Such subsidies have been deemed appropriate as advancing "Universal Service," so that all households, including lower income households, might be able to have telephone service. Those subsidies continue today, albeit in more explicit fashion, under various federal and state Universal Service support mechanisms including the federal Lifeline program.[24] We understand that similar established subsidies may exist within the Postal Service's monopoly (Market Dominant) services, for similar policy and societal reasons. We want to be clear, then, that when discussing cross-subsidy issues herein, and associated cost allocation issues, our focus is on subsidies flowing from monopoly services to competitive products, and in maintaining a level playing field in competitive markets.

A. STRUCTURAL SEPARATION

Structural remedies seek to quarantine monopoly-provided services in a separate corporate entity to eliminate the regulated firm's temptation to assign costs to regulated operations and compete unfairly in the unregulated markets. They avoid the difficult regulatory toiling of allocating joint and common costs associated with cost allocation remedies, but understandably are viewed as more extreme and interventionist. The most familiar example is the breakup of the old AT&T system. After years of

[24] *See* https://www.fcc.gov/general/lifeline-program-low-income-consumers.

Department of Justice scrutiny, the landmark 1982 Modified Final Judgment[25] in the AT&T antitrust case broke up AT&T into separate entities: the competitive, long distance provider AT&T, on the one hand; and newly created monopoly local service companies (Baby Bells, as they became known), on the other. This separation extinguished any possibility that local monopoly operations would cross-subsidize AT&T's competitive long-distance services, as AT&T exited the local service market. As we discuss in more detail in Section V, *infra*, AT&T argued that long distance competition would "threaten the integrity of the nationwide communication rate structure,"[26] and that after divestiture of AT&T's local service from its long-distance service "telephone service would deteriorate and cost much, much more."[27] That prophesy, of course, went unfulfilled.

B. LINE OF BUSINESS RESTRICTIONS

Line of business restrictions have also served to prevent leveraging of utility monopoly power. For instance, AT&T came under the antitrust microscope in the early 1950s with the advent of computers and the associated provision of competitive and generally unregulated computing "information" services, distinct from AT&T's traditional communications services provided on a regulated, common carrier basis. An antitrust

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[25] *United States v. AT&T,* Modified Final Judgment, 552 F.Supp.131 (D.D.C. 1982).

[26] *In re Applications of Microwave Communications, Inc.*, Docket No. 16509, Initial Decision of the Hearing Examiner, 18 FCC 2d. 979, 1004 (1967) ("*MCI Hearing Examiner Decision*").

[27] John Brooks, *Telephone* (Harper & Row 1975), p. 316.

case filed against AT&T resulted in a Consent Decree and Final Judgment that prohibited AT&T from providing these lucrative new computing services.[28]

Similarly, the divestiture of AT&T in 1982 allowed AT&T to retain its long-distance network, but spun out AT&T's local assets, and the right to provide local telephone service, to seven newly created Regional Bell Operating Companies ("RBOCs"), the aforementioned "Baby Bells." For a time these RBOCs remained monopoly providers of local service in their respective geographic footprint, but by the terms of the Modified Final Judgment in the AT&T divestiture, the RBOCs were prohibited from providing competitive interstate long-distance service. The 1996 Telecommunications Act opened the local service markets to competition, but still prohibited the RBOCs from providing interstate long-distance until such time as they could affirmatively demonstrate that their local markets had been fully opened to competition.[29]

Further, even after making that showing, RBOCs were initially required to offer interstate long-distance through a separate affiliate, again to help ensure that they would not cross-subsidize their competitive interstate long-distance offerings.[30] These

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[28] *United States v. Western Electric Co.*, 13 RR 2143 (D.N.J. 1956). This antitrust proceeding originally focused on, and sought the divestiture of Western Electric, AT&T's manufacturing affiliate that provided phones and other equipment to subscribers. The Consent Decree and Final Judgment allowed AT&T to retain Western Electric, for a time, in exchange for prohibiting AT&T from providing newly developing computing services. Even carriers other than AT&T and its Bell System subsidiaries were required to provide these new computing services through separate corporate entities due to cross-subsidization concerns. *FCC Separations Order*, 2 FCC Rcd at 1301. Ultimately, with the divestiture of AT&T in 1982, it was allowed to provide such services, subject to a variety of ongoing regulatory requirements and safeguards.

[29] 47 U.S.C. § 271.

[30] 47 U.S.C. § 272; *see AT&T Corp. v. FCC*, 369 F.3d 554, 556 (D.C. Cir. 2004) ("Section 272 adopts regulatory 'safeguards,' including structural and transactional requirements, nondiscrimination provisions, and enforcement mechanisms to deter a BOC from leveraging its local market power into long distance markets."); *see also*

kinds of separate affiliate requirements also exist at the state level, and can be viewed as "soft" structural separation or line of business restrictions,[31] requiring that non-price regulated products be provided through an affiliate or separate corporate division.[32]

Line of business restrictions fundamentally recognize that a provider of monopoly services in a regulated market can potentially unfairly leverage that monopoly power in adjacent competitive markets, and therefore flatly prohibit entry into the competitive market by the monopoly entity. As with structural separation, line of business restrictions bluntly eliminate cross-subsidy concerns.[33] However, accounting separation, as discussed in the next section, is more commonly utilized to address these concerns. In that regard, as explained below, "good cost allocation procedures are critical to the success of [any] system of nonstructural safeguards."[34]

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supra note 28, describing the original separate affiliate requirement for telecommunications carriers to provide computing services.

[31] *See, e.g.*, Texas Administrative Code, § 25-272(d)(1) governing electric utilities, and providing that: "A utility shall be a separate, independent entity from any competitive affiliate." Section 25.272 also establishes a number of other safeguards, and a specific code of conduct, regarding an electric utility's relationship with any competitive affiliate.

[32] *See, e.g.*, *National Assoc. of Regulatory Comm'rs. v. FCC*, 525 F.2d 630, 637 (D.C. Cir. 1976) ("[The FCC] requires that separate companies be established for the operation of cellular systems, and that separate account books and payrolls be maintained. This requirement is designed to prevent cross-subsidization of the activities of the cellular system by profits of the parent corporation . . . .") (internal citations omitted).

[33] *See, e.g.*, *FCC Separations Order*, 2 FCC Rcd at 1301, ¶ 16 (observing that the historical restriction on AT&T providing computing services was a "structural separation scheme [that] sought to control cost shifting in the form of misallocation of joint and common costs by simply forbidding joint operations and joint marketing.").

[34] *FCC Separations Order*, 2 FCC Rcd at 1327, ¶ 234.

C. ACCOUNTING SEPARATION

While structural remedies and line of business restrictions have been employed, monopoly utility services are more typically walled off from competitive services through accounting separation. The fundamental notion embodied in all approaches to accounting separation is to ensure, insofar as possible, that utilities do not subsidize competitive offerings through monopoly profits in a captive market. As the Supreme Court has observed, "[r]atemaking is, of course subject to the rule that the income and expense of unregulated and regulated activities should be segregated."[35]

The fundamental difficulty in utility industries is that many assets are used to provide both regulated and unregulated service, and many costs are therefore shared and common costs. In the gas, electric and telephone utility context, accounting separation therefore depends first upon the accurate division of costs between federal and state jurisdictions, and then the further divisions of costs between regulated and unregulated services within both federal and state jurisdictions.

By way of example, the FCC's Part 36 accounting rules first divide between the federal and state jurisdictions shared costs associated with shared assets.[36] These include, for instance, switches and telephone lines to customer premises, used to provide both interstate services (subject to FCC jurisdiction), and intrastate services (subject to state public utility commission jurisdiction). Once that separation is

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[35] *Federal Power Commission v. United Gas Pipeline Co.,* 386 U.S. 237, 243 (1967).

[36] *See, e.g.*, *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking*, 3 FCC Rcd 3195, 3206, ¶ 13, n. 21 (1988) ("Pursuant to the dual system of federal and state telecommunications regulation established under the Communications Act . . . telephone company costs are apportioned between state and interstate jurisdictions and recovered thereafter according to applicable federal and state regulatory policies.").

completed the costs that remain on the FCC side of the ledger are further subdivided between regulated and unregulated services pursuant to the FCC's Part 64 accounting rules, as, again, many assets are used to provide both regulated and unregulated services.[37] The goal of Part 64 separations is to "inhibit carriers from imposing on ratepayers for regulated interstate services the costs and risks of nonregulated ventures."[38] The FCC determined that these rules were necessary to "deter cost shifting both in the form of misallocation of joint and common costs and in the form of improper intracorporate transfer pricing."[39]

State cost allocation functions in much the same fashion. As with FCC Part 64 accounting for interstate jurisdictional costs, intrastate costs are separated between regulated and unregulated services. State cost allocation rules and codes of conduct exist to "ensure that regulated electric and gas utilities do not use ratepayer funds to subsidize nonregulated activities."[40] This is typically accomplished through a cost allocation manual ("CAM") filed by the incumbent monopoly provider of a utility service.[41] These CAMs can run to hundreds of pages, and provide detailed guidance

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[37] *See, e.g.*, *FCC Separations Order*, 2 FCC Rcd 1298.

[38] *Id.,* 2 FCC Rcd at 1299, ¶ 1.

[39] *Id.*, 2 FCC Rcd at 1299, ¶ 2.

[40] Section 40-3-114, Colo. Rev. Stat.; *see also* Maryland Code, Public Utilities, § 7-505(b)(13)(ii) ("The Commission shall require each electric company to adopt a code of conduct to be approved by the Commission by a date to be determined by the Commission to prevent regulated service customers from subsidizing the services of unregulated businesses or affiliates of the electric company.").

[41] *See, e.g.*, model Electric Utility Cost Allocation Manual published by the National Association of Regulatory Commissioners ("NARUC") (Jan. 1992), available at: http://pubs.naruc.org/pub/53A20BE2-2354-D714-5109-3999CB7043CE, and providing nearly 200 pages to guide cost allocation determinations for electric utilities. Historically the FCC also required carriers to file CAMs for the same reason. *See FCC Separations Order*, 2 FCC Rcd at 1299, ¶ 1; *In the Matter of BellSouth Corporation's Permanent*

on methods to track and code all the utility's activities, to facilitate accurate allocation of costs between the regulated and unregulated sectors of the business. The specific CAM requirements of course vary by jurisdiction, but they share the common goal of enabling accurate cost allocation to avoid subsidization of competitive services. As explained by the Maryland Public Service Commission:

> A CAM is a public service company's disclosure of the allocation of common costs between and among the regulated public service company and its affiliates, some or all of which may be "unregulated" -- meaning that the affiliate(s) are not subject to economic regulation by the Commission. The purpose of a CAM is to allow the Commission, parties to Commission proceedings, and other interested stakeholders to evaluate the legitimacy of allocations of common costs. Without this sort of disclosure, the Commission cannot evaluate whether the public service company is allocating a proportion of common costs properly chargeable to unregulated business activities to the regulated business, thereby raising costs to customers of the regulated company. Such activity would be an improper cross subsidy that would harm customers of the regulated services and give the unregulated affiliate an unfair advantage over its competitors.[42]

NARUC also publishes a Model Cost Allocation Manual and Guidelines for Cost Allocations and Affiliate Transactions.[43] Those cost allocation guidelines embody the best state practices on cost allocation. The principles are:

> 1. To the maximum extent practicable, in consideration of administrative costs, costs should be collected and classified on a direct basis for each asset, service or product provided.

Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, Memorandum Opinion and Order, 3 FCC Rcd 128, 133, ¶ 40 (1988) ("The purpose of the cost allocation manual is to provide a regulatory check on the ability of carriers to apportion their costs between regulated and nonregulated operations.").

[42] *In the Matter of the Application of Potomac Electric Power Company for Authority to Revise its Rates and Charges for Electric Service and for Certain Rate Design Changes*, Case No. 9092, Order No. 81147, 2006 MD. PSC LEXIS 30, *5 (Md. P.S.C. Dec. 11, 2006).

[43] http://pubs.naruc.org/pub/539BF2CD-2354-D714-51C4-0D70A5A95C65 ("*NARUC CAM Guidelines*").

2. The general method for charging indirect costs should be on a fully allocated cost basis. Under appropriate circumstances, regulatory authorities may consider incremental cost, prevailing market pricing or other methods for allocating costs and pricing transactions among affiliates.

3. To the extent possible, all direct and allocated costs between regulated and non-regulated services and products should be traceable on the books of the applicable regulated utility to the applicable Uniform System of Accounts. Documentation should be made available to the appropriate regulatory authority upon request regarding transactions between the regulated utility and its affiliates.

4. The allocation methods should apply to the regulated entity's affiliates in order to prevent subsidization from, and ensure equitable cost sharing among the regulated entity and its affiliates, and vice versa.

5. All costs should be classified to services or products which, by their very nature, are either regulated, non-regulated, or common to both.

6. The primary cost driver of common costs, or a relevant proxy in the absence of a primary cost driver, should be identified and used to allocate the cost between regulated and non-regulated services or products.

7. The indirect costs of each business unit, including the allocated costs of shared services, should be spread to the services or products to which they relate using relevant cost allocators.

Beyond fundamental cost allocation requirements, stringent "affiliate interest" rules also seek to ensure that transactions between the unregulated and regulated businesses are appropriately accounted for at fair market value to prevent cross-subsidization. The Texas Public Utilities Commission, for instance, requires full cost allocation between a regulated utility and its affiliates, and mandates any transactions between the two be non-discriminatory toward third parties in the competitive market.[44]

[44] Texas Administrative Code § 25-272(e); *see also NARUC CAM Guidelines*, No. 4.

The Illinois Commerce Commission similarly requires the same arms-length treatment of regulated utilities and competitive affiliates.[45]

FERC, which regulates interstate gas and electric utility services, has also adopted extensive allocation and affiliate transaction rules at the federal jurisdictional level, based on these same concerns:

> [A] franchised public utility and an affiliate may be able to transact in ways that transfer benefits from the captive customers of the franchised public utility to the affiliate and its shareholders. Where a franchised public utility makes a power sale to an affiliate, the Commission is concerned that such a sale could be made at a rate that is too low, in effect, transferring the difference between the market price and the lower rate from captive customers to the market-regulated affiliated entity.[46]

Because of this concern, FERC requires electricity generators to seek approval for transactions between regulated and non-regulated power-selling affiliates. This allows FERC to assess *ex ante* whether the regulated generation entity is unlawfully cross-subsidizing power sales at the expense of captive ratepayers. Former FERC Chairman Joseph Kelliher, commenting on FERC's affiliate interest rules, described "preventing cross subsidization" as a "core duty for the agency."[47]

From the utility regulator's perspective, we think effective cost allocation would be virtually impossible without employing guiding principles embodied in cost allocation manuals and affiliate interest rules and requirements. Further, effective accounting

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[45] Illinois Administrative Code § 450.20, Nondiscrimination for Electric Utilities in Affiliate Transactions.

[46] *Cross-Subsidization Restrictions on Affiliate Transactions*, Docket No. RM07-15-000, Order No. 707, 122 FERC ¶ 61,155 (FERC 2008) at 4 (citations omitted); *see also FCC Separations Order*, 2 FCC Rcd at 1299, ¶ 1 (to constrain cross-subsidies, adopting "rules for recording transactions between regulated telephone companies and their regulated affiliates.").

[47] Statement of Chairman Joseph T. Kelliher, FERC Open Commission Meeting (Feb. 21, 2008).

separation also depends upon accurate and reliable cost data, transparency and clarity in the cost allocation methodologies employed, and the direct assignment of costs to competitive products to the greatest degree possible. We explore these issues next.

IV. EFFECTIVE ACCOUNTING SEPARATION

As Kahn observed, the imperative to separate costs between regulated and unregulated affiliates is central to the integrity of the regulatory enterprise.[48] Lessons from the utility sector demonstrate that, in order to be effective in preventing cross subsidization, accounting separation must, at a minimum: 1) be based on accurate and reliable cost data; 2) approach cost assignment and allocation in a transparent manner; and 3) direct assign costs to the maximum extent possible, leaving to allocation only those joint and common costs that are truly incapable of being direct assigned. We address each of these imperatives in turn.

A. ACCURATE AND RELIABLE COST DATA

Accounting separation, to be effective, must be based on accurate and reliable cost data. As the FCC has observed, accurate cost data is the *sine qua non* in any rates-setting exercise.[49] This is particularly so given that the cost data to be analyzed is

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[48] Kahn, *supra* note 5, at xx.

[49] *See, e.g.*, *In the Matter of Commission Requirements for Cost Support Material To Be Filed with 1989 Annual Access Tariffs*, Order, 4 FCC Rcd 1662, 1664, ¶ 17 (1988) ("In many other cases the data provided by the LECs was deficient or unclear in some important way and necessitated the institution of time-consuming and burdensome investigations into the reasonableness of proposed rates. These investigations required the provision of cost support data that was lacking in the original filings . . . . In general, the requested information was available to the LECs and they were able to comply with our requirements. This data has proved extremely valuable in our rate investigations. If detailed cost information had accompanied the LECs' original filings, it is likely that we would have been able to achieve more definitive results in the initial tariff review process.").

provided by the entity being regulated,[50] and as we have observed, the regulated utility has an incentive to understate costs for its competitive services.[51] Use of a Uniform System of Accounts ("USOA") throughout regulated utility industries helps ensure that regulators have access to such accurate and reliable cost data.[52] In addition, "independent attestation and the underlying documentation [supporting cost allocations]" is "invaluable to [any] Commission's cost allocation monitoring activities."[53]

B. TRANSPARENCY

In order to allow the regulator to evaluate a monopoly provider's accounting separation of costs, the assignment and allocation methodology utilized by the monopoly provider must be reasonably transparent, and not leave the regulator and interested parties grasping to understand how costs were assigned. Where utility providers submit opaque cost allocation materials, employ ambiguous terms, or lack

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[50] *See, e.g.* Howard A. Shelanski, *Adjusting Regulation to Competition: Toward a New Model for U.S. Telecommunications Policy*, 24 Yale J. on Reg. 55, 78 (2007) ("A threshold problem with determining 'reasonable' rates for a service is that the information necessary for the relevant calculations is in the hands of the very company being regulated. So called 'moral hazard' problems thus arise because a firm can affect a regulatory agency's determination of allowable rates by manipulating underlying accounting data.") (Mr. Shelanski is the current Administrator of the Office of Information and Regulatory Affairs (OIRA)).

[51] *See, e.g.*, *FCC Separations Order*, 2 FCC Rcd at 1300, 1302, ¶¶ 10, 21 ("The advent in the mid-60's of private line competition, however, focused attention on the natural incentive that AT&T might have to lower rates for competitive services by imposing some of those costs of the services on the ratepayers for monopoly services . . . our realization that carriers would always have some natural incentive to shift costs to rate-of-return regulated activities impelled us to consider structural separation.").

[52] *See, e.g.*, *Medina Power Company,* Order Granting Declaratory Order, 71 F.E.R.C. P61264, 62055 (1995) ("one of the principal benefits of the Uniform System of Accounts is to ensure that accurate and reliable cost data are available to be used in setting cost-based rates").

[53] *FCC Separations Order*, 2 FCC Rcd at 1330, ¶ 254.

sufficient bases for cost assignment determinations, regulators may send them back to the proverbial drawing board. The FCC has been repeatedly instructive on this point:

> We require BellSouth to amend its manual to include all of its Part 32 costs and revenues required pursuant to this proceeding, including those costs that can be directly assigned by "unique code." The purpose of the cost allocation manual is to provide a regulatory check on the ability of carriers to apportion their costs between regulated and nonregulated operations. The manual must therefore reflect all of a carrier's costs and revenues that we must evaluate to ensure that the Commission's requirements are being met. Excluding an unspecified amount of costs and revenues from the manual does not provide us with sufficient information to ensure that the Commission's rules are being followed. Furthermore, the process that is used to identify costs for direct assignment must also be explained in amendments to the manual. BellSouth has said only that it uses a "unique code" to establish which costs can be directly assigned without functional analysis. We must have some additional understanding of this process in order to judge whether the apportionment process is reasonable.[54]

[54] *In the Matter of Bellsouth Corporation's Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs*, Memorandum Opinion & Order, 3 FCC Rcd 128, 133, ¶¶ 40-41 (1987); *see also In the Matter of American Telephone & Telegraph Company's Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs,* Memorandum Opinion and Order, 3 FCC Rcd 1786, 1790, ¶ 40 (1987) ("AT&T has also made use of a particular phrase that must be defined more specifically. Throughout its cost allocation proposals, AT&T states that various costs will be allocated 'based on accounting records.' In the introduction to its cost allocation proposals, AT&T states that accounting records can mean any number of things, including functional accounting codes, continuing property records, tax records, lease records, and responsibility codes. In order to form a judgment that the cost allocation proposals in AT&T's manual are reasonable, we must have a clear idea of the methodology that AT&T will use. Simply stating that 'accounting records' will form the basis of the allocation is insufficient. AT&T must specify which accounting records it will employ in each case. We require AT&T to amend its manual accordingly.") ("*AT&T Cost Allocation Manual Order*"); *In the Matter of American Telephone and Telegraph Company Petition for Limited Waiver of Comparably Efficient Interconnection Requirements of Third Computer Inquiry*, Memorandum Opinion and Order, 1993 FCC LEXIS 6551, *14 (Common Carrier Bureau 1993) (requiring AT&T "to develop and implement unique function codes that specifically identify [research and development] costs, in order to maximize the use of direct assignment and to avoid combining of research and development costs that can be directly assigned.").

Similarly, in order to ensure that the costs of transmission solutions are allocated fairly to the various parties benefitting from regional electric transmission services, FERC has articulated a number of transmission planning and costing principles for transmission providers, including one stressing the importance of transparency in accurate cost allocation: "The cost allocation method and data requirements for determining benefits and identifying beneficiaries for a transmission facility must be transparent with adequate documentation to allow a stakeholder to determine how [the cost allocation method and data requirements] were applied to a proposed transmission facility."[55] Further, while transmission providers have latitude to determine a specific cost allocation methodology to comply with this principle, "[e]ach cost allocation method must be set out clearly and explained in detail."[56]

C. MAXIMUM DIRECT ASSIGNMENT OF COSTS

The appropriate allocation of common costs is particularly critical to avoid cross-subsidization, and it is also the aspect of accounting separation most susceptible to error. Allocation of common costs to competitive products is often based on a percentage allocator factor, which introduces the distinct probability that an inappropriately small share of common costs will be attributed to competitive offerings, particularly since the monopoly provider has an incentive to understate costs for competitive offerings, as we have noted. For this reason, in the utility context, regulators have uniformly determined that it is essential to maximize the direct

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[55] Transmission Planning and Cost Allocation by Transmission Owning and Operating Public Utilities (FERC Order No. 1000), 76 Fed. Reg. 49,842, 49,932 (Aug. 11, 2011).

[56] *Id.*

assignment of costs.[57] Federal financial accounting standards also emphasize the importance of directly assigning costs to the maximum extent possible.[58] Accordingly, in recently evaluating Amtrak's cost assignment practices, the GAO observed that "[i]ndirectly locating a high percentage of costs rather than directly assigning costs increases the risk that revenue and expenses for a cost center of line of business will be misstated."[59]

Leaving significant common costs to be distributed through an allocation factor invites cross-subsidization, particularly where the allocation factor for competitive products is much smaller than that for regulated products.[60] It has been observed that there is a "tendency for the regulated firm to also favor overestimation of its common costs."[61] As a consequence, even where price floors (e.g., equal to estimated average

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[57] *See, e.g.*, 47 C.F.R. § 64.901(b)(2) ("In assigning or allocating costs to regulated and nonregulated activities [for telecommunications carriers] . . . [c]osts shall be directly assigned to either regulated or unregulated activities whenever possible."); *FCC Separations Order*, 2 FCC Rcd at 1299, ¶ 2 ("Costs are to be directly assigned to either regulated or nonregulated activities to the maximum extent possible"); *NARUC CAM Guidelines* ("To the maximum extent practicable, in consideration of administrative costs, costs should be collected and classified on a direct basis for each asset, service or product provided."); *SFPP, L.P.,* Opinion No. 511-A Order on Rehearing and Compliance Filing, 137 F.E.R.C. P61120, ¶ 96 (2011) ("The standard of review here is whether the direct assignment methodology SFPP advances here is reasonably designed to meet the ratemaking principle of maximizing the direct assignment of costs in a specific regulatory proceeding").

[58] *See Statement of Federal Financial Accounting Standards, Number 4.*

[59] GAO-16-67 at 13 (Jan. 6, 2016). The GAO recommended that the Federal Rail Administration work with Amtrak to identify changes to enable it to better directly assign costs. *Id.*

[60] *See, e.g.*, *FCC Separations Order*, 2 FCC Rcd at 1314, ¶ 120 ("emphasiz[ing] direct assignment of costs and discourage[ing] use of broad composite allocators except as a last resort . . . .").

[61] Burton, Kaserman, Mayo, *Common Costs and Cross-Subsidies: Misestimation Versus Misallocation* (2008), http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.568.7935&rep=rep1&type=pdf

costs) are adopted to govern pricing to attempt to prevent cross-subsidization of a regulated firm's competitive offerings, those price floors can be ineffective "[w]here the incumbent is able to mis-categorize some of its product-specific costs as common costs."[62]

Indeed, as we noted previously, former Secretary of the Treasury John Snow observed that the very large proportion of costs that the Postal Service does not directly assign, but leaves to allocation as overhead, was the "elephant in the room" regarding Postal Service cost allocation.[63] Former Secretary Snow emphasized "the importance of precise revenue and cost allocation across products as a key element to include in any successful postal reform."[64]

Perhaps not surprisingly, then, regulators have sometimes spurred regulated utilities to sharpen their pencils and improve their direct assignment of costs.[65] While

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62 *Id.*

63 *See supra*, note 15 and associated text.

64 *Id.*

65 *See, e.g.*, *AT&T Cost Allocation Manual Order*, 3 FCC Rcd at 1790, ¶ 34 (finding that "AT&T has not followed the Commission's directives to maximize assignment or attribution of costs, and to employ the general allocator only when more direct measures of cost causation are unavailable. AT&T's manual employs the general allocator for many accounts and cost pools, often without any attempt to directly assign or attribute costs first."); *In the Matter of Alascom, Inc., Cost Allocation Plan for the Separation of Bush and Non-Bush Costs*, Order, 10 FCC Rcd 4963, 4965-4966, ¶¶ 11, 17 (1995) (directing telecommunications carrier to resubmit its proposed cost allocation plan, where carrier used "'general allocators' to allocate costs in the administration and executive categories between regulated and unregulated activities, inquiring "why its allocation process produces limited direct assignment," and concluding that the carrier "may have to restructure its cost allocation process in order to increase its level of direct assignment."); *In the Matter of NYNEX Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs*, Memorandum Opinion and Order, 3 FCC Rcd 81, 91, ¶ 87 (1987) ("NYNEX proposes to use the general allocator to allocate costs in these accounts between regulated and nonregulated activities. We believe that NYNEX's method is insufficient and may result

utilities may claim that this degree of effort is burdensome, it is necessary where regulators rely on accounting separation to prevent abuse of monopoly power. As the FCC has observed, "[w]e believe that a carrier can assign, through the use of a well-designed cost allocation manual, a very high percentage of its costs on a cost causative basis."[66]

V. THE REGULATORY CHALLENGE

If the Commission is to prevent cross-subsidization and ensure a level-playing field for competitive services, it must ensure that the Postal Service's cost allocation methodologies appropriately and accurately assign costs. In our experience, however, monopoly providers seldom welcome change, and therefore are often sharply critical of proposals to upset the status quo. The AT&T example is illustrative.

Decades ago AT&T's monopoly extended to customer premises equipment through its manufacturing affiliate Western Electric. AT&T fiercely protected that monopoly for years by arguing that any foreign device attached to its network could compromise the integrity of the entire national telephone network. AT&T vigorously litigated that contention in the Hush-A-Phone case, which involved a small cup device that snapped onto the mouthpiece of a telephone to allow for more private conversation.

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in inaccurate cost allocations . . . . We therefore direct NYNEX to amend its manual to provide for more cost-causational methods for each of these accounts, or to justify in detail why it must resort to the general allocator."); Memorandum Order and Opinion, 3 FCC Rcd 5978, 5983, ¶¶ 49-52 (1988) (rejecting NYNEX's continued proposed use of a general allocator to apportion executive and planning costs, notwithstanding the FCC's rejection of that general allocator in its initial order, finding "unconvincing" NYNEX's claim that the "unspecific and general nature" of these expenses warranted their treatment as common costs, and determining that "many functions associated with NYNEX's corporate level and planning offices are reasonably susceptible to apportionment methods that are more accurate than general allocation.").

[66] *FCC Separations Order*, 2 FCC Rcd at 1319, ¶162.

The D.C. Circuit rejected AT&T's farfetched claims that the Hush-A-Phone posed a risk to AT&T's network, and compromised the quality of calls over that network, because it impaired the "naturalness" and "recognition" of the caller's voice.[67]

Undaunted by its Hush-a-Phone setback, AT&T next assailed the Carterfone device, which functioned as an early rudimentary speakerphone, similarly characterizing it as a threatening "foreign attachment."[68] The FCC disagreed, and allowed customers to continue to use their Carterfones, and AT&T's network, of course, did not fail. Tellingly, ten years after the FCC's Carterfone decision, AT&T's Chairman acknowledged that AT&T's network rhetoric had been overblown, and that the real issue was competition: "Already it has been a decade since the Carterfone case opened the network to equipment competition. But the world has not come to an end. Nor does the sky show imminent signs of falling."[69]

Similarly, in the late 1950s when the FCC first proposed to allow private carriers to use wireless spectrum to provide point-to-point communications, the existing few common carriers licensed to provide such communications, including AT&T, raised the predictable alarm.[70] Western Union, the old telegraph company, was also one of those few licensed carriers, and it predicted that "a private point-to-point communications system, would be, in fact, a perversion of the concept of competition and might well

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[67] *Hush-a-Phone v. United States*, 238 F.2d 266 (D.C. Cir. 1956).

[68] *In the Matter of Use of the Carterfone Device in Message Toll Telephone Service,* 13 FCC Rcd 420 (1968). The Carterfone allowed users to attach a two-way radio device to their AT&T phone, to allow for hands-free communication into the phone through the two-way radio, and was popular, for instance, in oil field work.

[69] Steve Coll, *Deal of the Century*, Collier McMillan Canada, Inc., p. 136 (1986).

[70] *See Allocation of Frequencies in the Bands Above 890 Mc.*, Report and Order, 27 F.C.C.R. 359 (1959).

destroy the ability of the telegraph company to operate at all.[71] Unmoved by Western Union's rhetoric, the FCC proceeded. Contrary to its prophesy of doom, Western Union continued to successfully operate for decades (at least until telegraph service became obsolete), and even significantly expand its own microwave communications systems.[72]

Further, the FCC's decision to allow competition in the provision of point-to-point services set the stage for the next logical step in telephony's competitive evolution. Eventually a number of new entrants, including upstart Microwave Communications, Inc. (the now familiar "MCI") applied to provide competitive point-to-point services via microwave facilities between major U.S. cities.[73] Existing carriers (primarily AT&T) immediately recognized the potential threat to their lucrative long-distance business, opposing MCI's application by attacking its business and facility deployment plans as untenable.[74] AT&T went so far as to argue that granting MCI a license would "threaten the integrity of the nationwide communication rate structure."[75] The "rest of the story" is

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[71] *Id.* at 389-90 ¶ 85.

[72] Federal Communications Commission, *Common Carrier Services*, Information Bulletin, Report No. 12-C-3-72, 28 (1972), http://files.eric.ed.gov/fulltext/ED064942.pdf.

[73] *MCI Hearing Examiner Decision*, 18 FCC 2d. 979.

[74] *Id.* at 1003-1004 (noting that "[f]rom the lofty viewpoint of the carriers [including, primarily, AT&T], MCI's system is jerrybuilt; they say that its equipment would be inadequately housed, exposed to storm and crippling extremes of heat and cold, and without standby equipment to supply power in inevitable periods of outage. Almost literally they leave no stone unturned, for they contend that the tower sites, even if accessible and available, would be so small that the supposititious farmer, imaginably careless in his hypothetical plowing, would turn up the guy wires and pull down the towers.").

[75] *Id.*; *see also* John Brooks, *Telephone* (Harper & Row 1975), p. 316 (noting comments of AT&T Chairman John D. DeButts that the divestiture of AT&T would "destroy a unique national resource," with the result that "telephone service would deteriorate and cost much, much more," yet another dire prophecy unfulfilled).

well known. Despite these dire warnings, the FCC approved MCI's application.[76] The integrity of the nation's communications system was never imperiled, and the MCI decision ushered in a competitive long-distance telephone market that has seen rates decline from more than $0.50/minute for some calls in the 1970s to essentially commodity levels today.[77]

Our point here is that monopolies, even if the monopolies are government owned, predictably tend to resist change, particularly significant change. The utility regulatory landscape is littered with numerous additional examples of extreme rhetoric and predictions of doom unfulfilled. We urge the Commission to sidestep the rhetoric in meeting its statutory charge to prevent cross-subsidization in the postal market and ensure a level-playing field for competitive services.

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[76] *In re Applications of Microwave Communications, Inc.*, Docket No. 16509, Decision, 18 FCC 2d 953 (1969).

[77] *See The Industry Analysis Division's Reference Book of Rates Price Indices and Household Expenditures for Telephone Service* p.62, Table 13 (FCC Common Carrier Bureau, March 1997), https://transition.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ref97.pdf*; see also Reach Out and Charge Someone: Long-Distance in the 1970s*, available at: http://flashbak.com/reach-out-and-charge-someone-long-distance-calls-in-the-1970s-21344/ (recalling the AT&T/Bell System 1970s "Phone Thing," a color-coded wheel that the customer could assemble to guide the customer through the labyrinthine AT&T long-distance day, time and distance pricing rules, and observing that "long distance rates were so steep that you could fill your tank up with gas for the price of talking on the phone for an hour. In most homes, long distance was forbidden except on weekends.).